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SUBJECT: Natural Gas in South China (Part 2 of 2): Chinese Taking Control as Offshore Exploration Looks Promising

REF: Guangzhou 418

GUANGZHOU 00000419 001.2 OF 005

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11. (SBU) SUMMARY: The Chinese government has renewed efforts to diversify the nation's energy mix and improve the environment by bringing anticipated large offshore gas reserves in the South China Sea (which had previously been ignored, vented or flared) to production. As offshore oil and gas fields in the South China Sea look more promising, exploration blocks previously operated by foreign-run joint ventures, are increasingly being consolidated under China National Offshore Oil Corporation (CNOOC) ownership. Overall, CNOOC continues to act less like a profit-seeking corporation and more inline with government desires to secure resources globally to quench China's growing energy thirst. Despite healthy financial returns in the past, most Western exploration and production companies are finding newly offered projects to be higher risk (the full extent of which will not be known until exploration begins), technically difficult to complete, in deeper water, and with operating control solely by CNOOC. This is the second of two cables on the subject of natural gas in south China. END SUMMARY.

In the Past, Foreign Companies Dominated

12. (SBU) CACT is a representative case of what foreign offshore oil and gas joint ventures are becoming today. Originally started in

1984, CACT was an equal partnership between AGIP (now ENI, the national oil company of Italy), Chevron, and Texaco to explore two blocks in the South China Sea. After seven years of exploration and development, the JV started production with seven offshore platforms in 1991. After 15 years, CNOOC exercised its option to purchase 51% of the venture in 1999 and the later merger of Chevron and Texaco adjusted the financial split to its current level - 51% CNOOC, 32% Chevron, and 16% ENI. For the past 7 years, operator rights have rotated among the three partners yearly as has the overall project manager position.

13. (SBU) Congenoff spoke to Mr. Maurizio Senese, Deputy Project Manager for CACT and the highest ranking manager from ENI in the JV, who stated management and engineering positions within the JV are no longer relinquished by CNOOC employees. The overall management of the JV has shifted from a mix of American, British, and Italians to Chinese. With the shift, the remaining Chevron and ENI management are largely ignored except when information needs to be passed back to respective company headquarters. The need to use foreign experts is declining rapidly and CNOOC is currently seeking permanent operator rights so it can ensure that all production from the fields is directed to China. Senese said that despite the fact that the CACT project was ENI's project with the highest rate of return in the world, the company will likely bow to Chinese pressure and financial incentives and sell their share in the project within the next few years.

14. (SBU) Mr. David Lindsay, President of Devon Energy China, one of the largest U.S. energy companies active in the South China Sea, told Congenoff that Devon is currently involved in a joint venture with Husky Energy (a Canadian energy firm majority-owned by Hong Kong billionaire Li Ka-shing) and CNOOC in the Eastern South China Sea. Following the trend described above, CNOOC recently purchased operator rights to the project in the Panyu field and Devon is now pursuing new exploration projects.

GUANGZHOU 00000419 002.2 OF 005

CNOOC Learns Quickly

15. (SBU) Mr. Senese commented that the number of foreign experts used in CACT projects had declined dramatically in the last few years. CNOOC Engineers and managers alike are often put on multiple projects at one time so they can learn a broad range of skills. CNOOC employees are moved from one CNOOC joint venture to another in an attempt to gain knowledge of techniques from different foreign partners. For depths up to 200 meters, Senese said that CNOOC is now competent and offshore joint ventures in these depths will continue to be bought out while new projects will be entirely owned and operated by CNOOC.

Finances Don't Govern All

16. (SBU) Congenoff spoke with Dr. Ziqiong Zheng, China Area Manager for Baker Hughes Inteq - a large U.S. oil and gas services firm, who commented that in offshore exploration and production, intellectual property rights protection is a large challenge. The Chinese oil services arms of CNOOC, Sinopec, and PetroChina are quick to copy drilling and logging technologies but so far the copied technology has yet to approach the original in quality. Still, for Chinese-only offshore projects, Baker Hughes is at a disadvantage due to protectionism and favoritism. Without changes in the business environment, it will suffer due to the diminishing role of international oil and gas companies in South China Sea projects.

17. (SBU) Dr. Zheng notes that the China oil majors continue to favor Chinese-made or controlled equipment, even when it is less efficient. He cited project examples where Baker Hughes technology was seemingly more expensive, costing \$26000 USD per day compared to \$10000 USD for similar Chinese-made equipment. Since the Baker Hughes designed drilling system can run for 200 hours before needing to be changed out, a process that can take multiple days at great depths, compared to only 40 hours for the Chinese-made equivalent, the Baker Hughes option actually costs up to \$2.5 million USD less

and more importantly, can bring a deep-water well to production a year sooner. Yet CNOOC and other Chinese oil majors routinely use their own service companies for drilling and often cite social stability as the reason.

¶18. (SBU) The Chinese oil and gas industry currently employs 1.2 million people in China (down from a peak of 2 million) and 85% of these are in support services as varied as schools, hospitals, and food preparation. Most Chinese managers are not willing to risk a few million dollars in savings on a project if the outcome can lead to large domestic layoffs and civil unrest. Still, Dr. Zheng stated the future for foreign oil services companies in offshore projects may be brighter than it appears due to the increased government emphasis on bringing domestic offshore production of oil and gas to market quickly.

South China Sea Prospects Look Bright...

¶19. (SBU) Both Mr. Senese and Dr. Zheng commented that the South China Sea is full of potential. The South China Sea is divided by CNOOC into the Eastern South China Sea which encompasses the Pearl River Delta and waters to the south and east and the Western South China Sea which encompasses the waters west of the Pearl River Delta including those south and west of Hainan island. So far, the Eastern South China Sea has primarily produced oil and the Western South China Sea has produced natural gas. This is slowly changing as CNOOC is now attempting to send gas from its wells in the Panyu field in the Eastern South China Sea by pipeline through CACT's

GUANGZHOU 00000419 003.2 OF 005

existing platforms in the Huizhou field and then onward to the city of Zhuhai. The pipeline from CACT's platforms to Zhuhai has been completed but a faulty Chinese-engineered jacket for a well (the largest ever designed by China for offshore use at 213 meters) on CNOOC's Panyu-30 platform was discovered last year and now is being replaced. This has delayed the rest of the project by over a year. Once the project is completed, it will produce over 400,000 tons/year of natural gas to be used to fire power plants in southern Guangdong province.

¶10. (SBU) Mr. Senese showed Congenoff a set of maps depicting potential oil and gas fields in the South China Sea. Based on current seismic data the finds could be huge as over 90% of expected fields have yet to be explored or developed. Many of the fields currently in production are also small compared to the potential that lies in deeper water.

¶11. (SBU) In June 2006, Husky Energy announced the discovery of one of the largest Chinese offshore natural gas deposits in the Liwan Field of the Western South China Sea. The potential recoverable resource is estimated at between 4 and 6 trillion cubic feet of natural gas (77.8 to 116.7 million tons). Mr. Lindsay stated that Devon owned exploration rights to the adjacent field and seismic data indicated analogous structures which could mean a similar size discovery. These fields lie in depths of at least 1500 meters of water.

Future Work with CNOOC Looks Less So

¶12. (SBU) Mr. Senese stated that future foreign JVs with CNOOC would likely be on projects in depths of 1000 meters or greater. He continued that CNOOC has the expertise for exploration at these depths but lacks experience in development and production as evidenced by CNOOC's faulty attempt at only a 213 meter jacket last year. The phasing out of tax incentives for foreign firms and a new oil export tax may also affect international oil and gas firms' willingness to enter new joint ventures.

¶13. (SBU) Mr. Lindsay commented that most of the new shallow-water blocks being offered were unattractive. However he stated that when blocks do come up for offer relationships are extremely important. Unlike many other countries where blocks are put up for auction, in China, CNOOC negotiates individually with partners on each block based on precedence of expressed interest. These negotiations often

take a long time. Dealing with CNOOC is further complicated by the company's decentralized structure. CNOOC-Shenzhen handles Eastern South China Sea fields but CNOOC-Zhanjiang manages Western South China Sea fields. For companies like Devon with interests in the East China Sea and Bohai Bay as well, the company must also deal with CNOOC-Shanghai and CNOOC-Tianjin respectively. This can stretch a lightly-staffed international oil company thin.

¶14. (SBU) Eni's Senese stressed relationships with CNOOC were also important in joint ventures. He stated that Chevron's open lobbying against CNOOC during the company's bid for Unocal turned the company and its representatives into non-entities at CACT. Devon's Lindsay also commented on the possible folly of a Conoco-Philips decision to take China to arbitration over a questionably legal windfall tax implemented on oil production last year. While all international oil companies agreed the tax, which amounted to \$12/BBL at peak oil prices, was questionable, the decision to formally fight it could hurt Conoco-Philips more in the long term.

¶15. (SBU) Dr. Zheng agreed that the divided structure of CNOOC poses several challenges but also commented that the biggest obstacles for foreign companies are the lack of complete geological information on

GUANGZHOU 00000419 004.2 OF 005

blocks. CNOOC often paints a rosy picture but most blocks that are opened for foreign participation are actually high risk or technically difficult to complete and the foreign partner often won't know the full extent of the risk until after a deal is struck.

Lindsay stated that his company looked at some of these opportunities as high risk but minimal investment, implying a willingness to cease exploration if early wells don't show results.

Rigs are the Bottleneck

¶16. (SBU) Mr. Senese, Dr. Zheng, and Mr. Lindsay all agree that the overall worldwide lack of drilling rigs is a major bottleneck to quicker exploration and development of the South China Sea. With CNOOC purchasing a stake in the gas fields of Indonesia to support the CNOOC's Fujian LNG project, it has moved several of its own drilling rigs from the South China Sea. Furthermore, when CNOOC-owned rigs become available, CNOOC wholly-owned projects are given preference to those of CNOOC JVs. International oil firms are seeking rigs worldwide but with the major rig yards already at capacity for new production and high demand and commodity costs pushing up rig prices, the proven reserve threshold for new projects is also correspondingly higher. As a result, CNOOC and others currently seem content to add extended-reach wells to existing platforms rather than develop entirely new fields in the South China Sea.

CNOOC and China, Combining Efforts in the Developing World

¶17. (SBU) Mr. Lindsay has been in China for only one year, previously heading up Devon's operations in Equatorial Guinea. He commented on the extreme difficulty of dealing with the government there. Both Lindsay and Dr. Zheng mentioned the impact that the Foreign Corrupt Practices Act (FCPA) can have in the developing world. The government backing of national oil companies such as CNOOC compounds the problem. In West Africa, CNOOC is able to link Chinese government financial and aid projects to preferential treatment on energy deals.

Comment

¶18. (SBU) While there are numerous promising fields in both the Eastern and Western South China Sea, increased ownership and control of projects by CNOOC will likely slow the rate at which these fields are explored and developed. In the case of the potentially large natural gas finds off Hainan Island, billions of dollars worth of investment will be needed to bring the gas to market. The cities of Zhuhai and Zhanjiang in Guangdong province will be likely hubs for offshore natural gas. Current plans to connect Zhuhai to Guangzhou and Shenzhen via pipeline depend on completion of an LNG terminal

that has yet to receive final approval or begin construction (see reftel) and completion of this pipeline will be in 2012 at the earliest. Until then, the natural gas coming from the Eastern South China Sea will continue to be used almost exclusively for power generation in Zhuhai.

¶19. (SBU) CNOOC, and China in general, are handling natural gas and other offshore exploration with a mercantilist approach. The overriding goal is control of assets, technology, and resources. CNOOC is willing to use international oil majors and oil and gas service companies only when it needs the expertise and in these cases the company seeks to gain new technologies and skills as quickly as possible to minimize future dependence. Using lucrative financial offers is still bringing in foreign partners and CNOOC continues to build relationships, sometimes with government help,

GUANGZHOU 00000419 005.2 OF 005

worldwide. CNOOC also uses the threat of minimizing these relationships as a potential retribution for those companies who cross it as it attempts to gain further control of the offshore situation in China and other nations. Overall, CNOOC continues to act less like a profit-seeking corporation and more inline with government desires to secure resources globally to quench China's growing energy thirst.

Note of Conversions

¶20. (U) In this cable, the following conversion factors were used in computing equivalents:

1 cubic meter natural gas = 35.3 cubic feet natural gas

1 MMBtu = 27.993 cubic meters of natural gas

51414 cubic feet of natural gas = 1 ton of natural gas

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